DEPARTMENT OF STATE REVENUE
SECOND SUPPLEMENTAL LETTER OF FINDINGS NUMBER 00-0256
FINANCIAL INSTITUTIONS TAX
For the Tax Years 1996 and 1997

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ISSUE

I. Service Fee Income From Securitizations as a Qualifying Transaction Under the Financial Institutions Tax.

Authority: IC 6-5.5 et seq.; IC 6-5.5-1-17; IC 6-5.5-1-17(d); IC 6-5.5-1-17(d)(2)(A), (B); 45 IAC 17-2-1(a); 45 IAC 17-2-4(b), (c); 45 IAC 17-2-4(b)(1)-(3); 45 IAC 17-2-4(e)(1); 45 IAC 17-2-4(e)(2).

Taxpayer protests the determination, contained within the previous Supplemental Letter of Findings (SLOF), that service fee income derived from the securitization of various loans, was not a "Qualifying Transaction" that could be accumulated in order to qualify taxpayer to file under Indiana's Financial Institutions Tax.

STATEMENT OF FACTS

Taxpayer is a non-resident corporation engaged in the business of leasing and financing the purchase of construction equipment and engines. Taxpayer does this by entering into various forms of transactions between itself, taxpayer's local dealerships, municipalities, individual customers, and certain third-parties.

The previous SLOF considered certain of these transactions and whether they constituted "Qualifying Transactions" serving to bring taxpayer within the purview of the state's Financial Institutions Tax. The previous SLOF concluded that income derived from the securitization of taxpayer's loans did not derive from a "Qualifying Transaction." Rather, the earlier SLOF concluded that when taxpayer marketed certain of its loans to third-parties, but continued to derive income from servicing the loans, the taxpayer was no longer in the business of extending credit.

Taxpayer requested and was granted an opportunity to revisit this issue.

DISCUSSION

I. Service Fee Income From Securitizations as a Qualifying Transaction Under the Financial Institutions Tax.

Taxpayer's basic contention is that, because of the manner in which it conducts its business of leasing and financing the purchase of construction equipment and engines, taxpayer comes within the definition of a financial institution pursuant to 45 IAC 17-2-4(d)(1), (2).

Indiana imposes a franchise tax, know as the Financial Institutions Tax (FIT) on corporations transacting the business of a financial institution inside the state. IC 6-5.5 et seq. The FIT is imposed on residential financial institutions, nonresident financial institutions, and on certain non-bank entities that transact the business of a financial institution. 45 IAC 17-2-1(a). Non-resident corporations, such as the taxpayer, transacting the business of a financial institution, are subject to the FIT, when the non-resident corporation demonstrates that it has established an economic presence in Indiana pursuant to IC 6-5.5-3-1. It is not disputed that taxpayer has established an economic presence in Indiana.

Because the taxpayer is plainly not conducting the business of a traditionally regulated financial institution as defined in IC 6-5.5-1-17(d), taxpayer premises its claim to FIT status under the provisions of IC 6-5.5-1-17(d)(2)(A), (B) which grant FIT status to those corporations which obtain 80 percent of their gross income from the "[m]aking, acquiring, selling, or servicing loans or extensions of credit" or from the "leasing [of] real and personal property that is the economic equivalent of the extension of credit if the transaction is not treated as a lease for federal income tax purposes."

The benchmark for determining whether a taxpayer is "conducting the business of a financial institution" is if 80 percent of the corporation's gross income is derived from the economic equivalent of extending credit. 45 IAC 17-2-4(b), (c). The taxpayer may reach this 80 percent benchmark various ways. It may do so by deriving 80 percent of its income from "(1) Extending credit . . . (2) Leasing that is the economic equivalent of extending credit [or] (3) Credit card operations." 45 IAC 17-2-4(b)(1)-(3). However, in order to demonstrate that it is it is entering into leases which are the "economic equivalent extending credit," the taxpayer must demonstrate that the lease income is derived from a transaction which is both "the economic equivalent of the extension of credit" and from a lease transaction which is "*not* treated as a lease for federal income tax purposes." 45 IAC 17-2-4(e)(2).

Taxpayer, initially protesting the audit's determination that it did not qualify to file under the FIT, submitted evidence of various transactions which – under their cumulative weight – purportedly brought the taxpayer to the 80 percent benchmark figure. The Department determined that certain of those transactions were "Qualifying Transactions" because, under the standards set out in the original Supplemental Letter of Findings, the

transactions were both the equivalent of extending credit and were *not* treated as a lease for federal income tax purposes.

However, the Department determined that certain income derived from one of the taxpayer's transactions did not originate from a "Qualifying Transaction." The income at issue was "service fee income on securitizations." This income results when taxpayer markets to third-parties loans previously entered into with various local dealers and customers. Although taxpayer has "sold" the loan to a third-party, taxpayer continues to service the loan by collecting monthly payments and doing that which is necessary to enforce the terms of the loan. From the viewpoint of the customer or local dealer the transaction, whereby the taxpayer sold the loan to the third-party, is entirely transparent. The customer or local dealer continues to deal directly with the taxpayer. By continuing to service the loan and collect loan payments, taxpayer earns "service fee income on securitizations." This income is derived from the "spread" (difference) between what taxpayer collects from customer or local dealer and what the taxpayer then turns over to the third-party. As an example, taxpayer collects payments from customer or local dealer consisting of principal and 5 percent interest. Taxpayer forwards to third-party the amount of principal and 4 percent interest. Taxpayer retains 1 percent interest for itself. The 1 percent retained interest represents "service fee income on securitizations."

The Department originally determined that this "service fee income on securitizations" did not derive from a "Qualifying Transaction" on the grounds that that taxpayer had removed itself from the business of extending credit and was in the business of providing loan services on behalf of the third-party. The previous SLOF found that the taxpayer was one step removed from the actual loan transaction and was in the business of providing services ancillary to the actual loan.

IC 6-5.5-1-17 defines those taxpayers which are qualified to file under the state's FIT. In addition to extending credit and entering into leases which are the economic equivalent of extending credit, taxpayers may reach the 80 percent bench mark from activities which include "[m]aking, acquiring, selling, or servicing loans or extensions of credit." IC 6-5.5-1-17(d)(2)(A). The Department's regulation restates the identical principle. The taxpayer may reach the 80 percent bench mark by "[m]aking, acquiring, selling, or servicing loans or extensions of credit." 45 IAC 17-2-4(e)(1).

The Department's original determination concerning taxpayer's service fee income on securitizations was erroneous. Neither the statute nor the regulation evince any requirement that income derived from "servicing loans" must be income derived from servicing the taxpayer's *own* loans. *See* IC 6-5.5-1-17(d)(2)(A); 45 IAC 17-2-4(e)(1). The fact that taxpayer has marketed certain of its loans but continues to derive income from servicing those loans, on behalf of an unrelated third-party, is irrelevant to the analysis. Taxpayer's "service fee income on securitizations" represents income derived from servicing loans and may be accumulated to qualify taxpayer to file under the state's Financial Institutions Tax.

However, it should be noted that the determination reached within this Supplemental Letter of Findings does not affect the Department's ultimate conclusion concerning the taxpayer's qualifications to file under the FIT. Even after determining that taxpayer's "service income from securitizations" represents income derived from a Qualifying Transaction" and, after accumulating that income with the taxpayer's income from other Qualifying Transactions, taxpayer fails to meet the 80 percent benchmark necessary to file under the state's Financial Institution's tax.

FINDING

Taxpayer's protest is sustained.